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UNCLAS SECTION 01 OF 02 OTTAWA 001265

SIPDIS

SENSITIVE

DEPT FOR EB/IFD, WHA/CAN AND WHA/EPSC  
STATE PASS CEA FOR Randy Kroszner, FRB FOR C. BERTAUT  
STATE PASS USTR FOR RYCKMAN  
TREASURY FOR OASIA/IMI - HARLOW, MATHIEU  
USDOC FOR 4320/MAC/ON/OIA/JBENDER  
PARIS ALSO FOR USOECD  
CALGARY PASS TO WINNIPEG

E.O. 12958: N/A

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SUBJECT: CANADIAN ECONOMIC UPDATE: NORTHERN TIGER BEING TAMED

REFS: (A) OTTAWA 0160 (B) OTTAWA 0500; (C) Toronto 1210, 1226, 1259 (D) Ottawa 1180 (Winnipeg)

11. Sensitive but unclassified, please protect accordingly. Not for Internet distribution.

Summary

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12. (SBU) The tiger's roar is beginning to weaken. In spite of a strong energy sector, respectable domestic demand and sound provincial finances, forecasters, including the Bank of Canada, have downgraded their growth outlook for the Canadian economy in 2003 from nearly 4% just a few months ago, to 2.5- 3%. February's GDP data, showing annualized GDP growth of only 2.4% compared to a 6% annualized rate just a month earlier, lends support to these downward revisions. Short-term concerns include continued global economic uncertainties, especially a delay in the U.S. economic recovery, a stronger than anticipated Canadian currency, and the impact of SARS in Toronto, capitol of Canada's largest province and source of 20% of national GDP.

13. (SBU) There are some glimmering bright spots, most notably Canada's energy sector and the relatively strong fiscal position of Canada's ten provinces. In fact, all but Prince Edward Island and British Columbia project balanced books or better, although once the full impact of SARS emerges, Ontario's estimated C\$524/US\$367 million surplus could erode into a deficit. The recent sharp rebound in U.S. consumer confidence bodes well for Canada next year, and the Conference Board of Canada projects that the quick victory in Iraq will trigger an economic recovery in the United States beginning in the third quarter of 2003. A U.S. economic rebound will be necessary to keep the Canadian tiger roaring. Our January forecast called for Canadian economic growth of 3.5% this year, increasing to 4.3% in 2004. We are modifying our forecast to around 3% this year and just under 4% in 2004. End Summary.

Northern Tiger Getting Tamed

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14. (U) The Canadian economy is still chugging along, but less energetically than just a few months ago. In February, real GDP rose a modest 0.2% from January, an annualized rate of 2.4%, representing a sharp moderation from the 6% annualized rate recorded just a month earlier. In addition, February's gain was narrowly based, with the continuing boom in housing construction and its spinoffs to industries such as concrete and wood products one of the few consistent sources of strength. Consumer spending continues to advance based on a rebound in auto sales, but weakness in manufacturing was evident in two-thirds of the major industry groups.

The Only Thing Certain Is Uncertainty

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15. (U) Looking ahead, several analysts are projecting extended weakness in Canada's export sector (about 38% of GDP) because of the sluggish global economy, a delay in the U.S. recovery, and stronger than expected appreciation of Canada's dollar. Canada's record employment growth of last year has begun to ease and the SARS outbreak in Toronto has already had an impact on the capitol of Canada's largest province and source of over 20% of Canada's economic output -- ref C. (Note: The Conference Board of Canada estimates the loss from SARS at C\$1 billion in 2003, or about half a percent of real GDP growth in a C\$2 billion economy. End note.) Consequently, several economists have downgraded their forecasts of the Canadian economy for 2003 from nearly 4% just a few months ago, to 2.5-3%.

16. (U) The Bank of Canada's April 23 Semi-annual Monetary Policy Report highlights the still-uncertain global environment, a delay in the U.S. economic recovery, and the SARS outbreak in Toronto, as factors tempering upward pressure on interest rates in the short-term. (The BOC raised rates by 25 basis points on March 4 and April 15 of this year.) The BOC says that while rising interest rates and appreciation of the Canadian dollar (up 8% since October 2002) have tightened monetary conditions in the past year, the BOC continues to believe that further reduction in monetary stimulus will be necessary to return Canada's inflation rate (4.3% in March; down from 4.6% in February) to the 2% target and to sustain output levels close to capacity.

Provincial Finances for FY2002-03: Lookin' Good (Sort Of)

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17. (SBU) The tally of provincial budgets shows an aggregate deficit of C\$1.3/US\$0.9 billion. (Due primarily to a C\$3.8/US\$2.7 billion deficit projection for British Columbia.) The only other province projecting a deficit is Prince Edward Island, but it is a marginal C\$8/US\$6 million. Energy-rich Alberta turns in the best fiscal performance projecting a C\$1.8/US\$1.3 billion surplus. In fact, Canada's cash-rich oilpatch faces a spending dilemma as record quarterly profits of Alberta's oil companies pour into the province. The consensus is that most firms will increase capital spending, look for merger opportunities, and pay down debt. In Ontario, the possible C\$1 billion cost of responding to SARS could erode the C\$524/US\$367 million surplus projection into a deficit. Although the virus is now contained (Toronto 1259), the economic hit in the city that contributes 20% to Canada's national GDP is already clear. As of April 25, there had been reports of a 50% drop in Toronto hotel occupancy rates, and a 70 to 80% loss of business for Chinatown restaurants and shops, and an average contraction of 30% in downtown retail sales (Toronto 1226). Quebec, the second-largest provincial economy, also projects a balanced budget but recent rumors of financial irregularities may cast a shadow there as well. The remaining provinces project small budget surpluses.

ALL SIGNS POINT TO RECOVERY IN 2004

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18. (SBU) Glimmers of hope on the horizon that should boost Canadian economic output late this year and in 2004 include Canada's energy sector and the relatively strong fiscal positions of the federal and provincial governments. The recent sharp rebound in U.S. consumer confidence bodes well for Canadian exports and manufacturing in the mid-term. The Conference Board predicts that the quick victory in Iraq will trigger economic recovery in the United States beginning in the second half of 2003, fueling a solid export recovery in Canada in 2004. Consequently, the Board forecasts Canadian economic growth of 2.7% this year and 3.3% in 2004. The Bank of Montreal shares the Conference Board's assumptions, and forecasts 2.4% growth in 2003, rising to 3.9% in 2004. Our January forecast predicted growth of 3.5% this year, increasing to 4.3% in 2004. Given the change in circumstances, we will scale back our forecast to around 3% for this year and to just under 4% in 2004.

Cellucci